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In the Supreme Court of the United States

OCTOBER TERM, 1982

W.H. PLANT, JR. AND
DORIS D. PLANT, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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The question presented in this federal income tax case is whether petitioners, who disposed of standing timber under a long-term cutting contract which does not oblige the other party to cut the timber, retained an economic interest in the timber under Section 631(b) of the Internal Revenue Code of 1954 (26 U.S.C.) with respect to minimum annual payments that they received in advance of cutting and are entitled to retain regardless of whether timber ever is cut. The decision below held that those payments did not represent a retained economic interest in timber and therefore were not eligible for capital gains treatment.

The stipulated facts may be summarized as follows: In February 1967, petitioners, W.H. Plant, Jr. and Doris D. Plant, entered into an agreement with the Hammermill

Paper Company, under which petitioners contracted to sell to Hammermill "all the timber standing and growing" on designated tracts during the 20-year term of the contract. The price, subject to adjustment according to the Wholesale Commodity Price Index, was $6.00 per cord for pine pulpwood and $2.50 per cord for hardwood. The agreement required Hammermill to pay for at least 2,000 cords of pine pulpwood per year, regardless of the actual annual harvest. The agreement also provided that Hammermill had no obligation to cut timber: [Hammermill] "shall be under no obligation to cut and remove any quantity of timber in any one year." If Hammermill cut more than 2,000 cords in any one year, the compensation for the excess was payable at the end of the year. In the event that Hammermill cut fewer than 2,000 cords during a year, a "timber backlog" clause authorized Hammermill to harvest the timber paid for in advance at any time prior to the expiration of the agreement. At the termination of the agreement, Hammermill's right to cut expires and petitioners may retain as "liquidated damages" any advance payments not credited against harvested timber (Pet. App. A-1 to A-2 & n.3, A-11 to A-12).

It is undisputed that during the years in suit — 1973 through 1975 — Hammermill cut no timber (Pet. App. A-2 & n.5, A-12). Nevertheless, by reason of its obligation to pay minimum annual payments, Hammermill paid petitioners $47,391.38. Petitioners reported this income as capital gains under Section 631(b) of the Internal Revenue Code of 1954. On audit, the Internal Revenue Service disallowed capital gains treatment on the ground that petitioners had not retained an economic interest in timber with respect to payments received in advance of cutting. It therefore determined that the payments were ordinary income (Pet. App. A-2, A-12).

In this refund suit brought by petitioners in the United States District Court for the Northern District of Alabama, the district court upheld the government's position that the payments in question were ordinary income. The court reasoned that the payments were not necessarily conditioned on the subsequent severance of timber because Hammermill was under no obligation to cut timber and petitioners were entitled to the advance payments whether or not timber was cut. The court therefore concluded that petitioners had failed, insofar as the payments at issue were concerned, to retain an economic interest in the timber as required by Section 631(b) (Pet. App. A-14 to A-15). The court of appeals affirmed on the authority of *Crosby* v. *United States*, 414 F.2d 822 (5th Cir. 1969) (Pet. App. A-5 to A-6).[1]

1. The decision below correctly held that petitioners were taxable at ordinary income rates on the minimum annual payments received from Hammermill under the timber contract.

Sections 631(b) and 1231(b)(2) of the 1954 Code (26 U.S.C.) (Pet. App. A-17 to A-18) provide that the disposal of timber "under any form or type of contract by virtue of which * * * [the] owner retains an economic interest in such timber" is to be treated as the sale of property used in the taxpayer's trade or business for purposes of Section 1231 of the 1954 Code (26 U.S.C. (& Supp. V)). Under Section 1231, the gains and losses on sales of property used in a trade or business are to be aggregated; if such sales show a net gain, that gain is treated as a capital gain. Thus, if the advance payments in question were attributable to a

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[1] In *Bonner* v. *City of Prichard*, 661 F.2d 1206 (1981), the Eleventh Circuit adopted the case law of the former Fifth Circuit as binding precedent (Pet. App. A-1 n.1).

retained economic interest in the timber, petitioners are entitled to capital gains; if not, they are subject to ordinary income rates.

Every court that has considered a timber cutting contract providing for advance payments, with no obligation imposed upon the payor actually to cut the timber, has ruled that with respect to the advance payments the taxpayer did not retain an economic interest in the timber. *Crosby* v. *United States*, 414 F.2d 822, 825 (5th Cir. 1969); *Superior Pine Products Co.* v. *United States*, 201 Ct. Cl. 455, 462-463, 481, cert. denied, 414 U.S. 857 (1973). See *Gammill* v. *Commissioner*, 62 T.C. 607, 619-620 (1974). These decisions are based upon the premise that an economic interest is retained only when the taxpayer possesses an interest in the property "to which he must look for a return of his capital." Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.611-1(b)(1). Accord, *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 314 (1956) (footnote omitted). Thus, in order for a taxpayer to retain an economic interest in timber, it is "essential" that the consideration "be contingent upon the severance of the timber, and payable to the owner solely out of the proceeds from the natural resource itself." *Dyal* v. *United States*, 342 F.2d 248, 252 (5th Cir. 1965) (footnote omitted). Accord, *Superior Pine Products Co.* v. *United States, supra*, 201 Ct. Cl. at 481.

Here, petitioners did not retain an economic interest in the timber with respect to the payments at issue because they were entitled to the advance annual payments whether or not Hammermill ever cut additional timber. Hammermill was not obligated to cut timber that had been paid for in advance, nor were petitioners required at the termination of the agreement to refund advance payments in excess of the value of timber harvested. In these circumstances, petitioners had no economic interest in the timber because they were not required to look to the timber for a return of their

capital. See W. Albritton, *Handling Timber Sales*, Fed. Taxes Oil & Gas Nat. Resources (P-H) paras. 1022, 1022.2 at 1484, 1022.4 at 1489 (June 28, 1979).

2. The decisions of this Court upon which petitioners rely (Pet. 5) are distinguishable because they involve the taxation of oil and gas, and not timber. To be sure, for years prior to 1975, taxpayers who received royalties or bonuses in advance of the production of oil and gas were eligible for the allowance for depletion with respect to those payments.[2] Such payments were treated as "payment in advance for oil and gas to be extracted." *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). See *Burnet* v. *Harmel*, 287 U.S. 103, 111 (1932). Thus, a taxpayer receiving such payments was treated as retaining an economic interest in the oil or gas, with the result that such payments were eligible for the allowance for depletion. The lower courts, however, have consistently treated timber differently from oil or gas or hard minerals. As the Tax Court has observed, the courts have reached "overwhelming consistency * * * in cases dealing exclusively with timber contract rights * * *."

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[2]The Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501, 89 Stat. 47, changed the law with respect to the percentage depletion allowance for oil and gas, effective January 1, 1975. The question whether taxpayers who received advance royalties and lease bonuses that are not based on actual production during the taxable year may still claim percentage depletion for these payments is pending before the Court. *Commissioner* v. *Engle*, cert. granted, No. 82-599 (Jan. 10, 1983) and *Farmar* v. *United States*, cert. granted, No. 82-774 (Jan. 10, 1983).

Contrary to petitioners' suggestion (Supp. Pet. 1-2), *Engle* and *Farmar* do not present the "very same issue" presented here. Those cases turn entirely upon the correct application of the provision of Section 613A(c)(2)(A) of the 1954 Code, as added by Section 501(a) of the Tax Reduction Act of 1975 (89 Stat. 42), that requires the allowance for percentage depletion for oil and gas to be computed on the basis of the "average daily production * * * [during the] taxable year." Section 613A pertains only to oil and gas, and has no relevance to the taxation of timber.

Gammill v. *Commissioner, supra,* 62 T.C. at 620. Accordingly, in timber cases arising under Section 631(b), a taxpayer is not entitled to capital gains unless he is required to look to the severance of timber for annual payments due under a timber cutting contract. *Crosby* v. *United States, supra; Superior Pine Products Co.* v. *United States, supra; Dyal* v. *United States, supra.* See *Gammill* v. *Commissioner, supra,* 62 T.C. at 619-620. Cf. *Giustina* v. *United States,* 313 F.2d 710, 713-714 (9th Cir. 1962) (contrasting the lease of rights to explore for and extract oil and gas with the disposition of standing timber). Here, the advance payments were not necessarily attributable to the severance of timber because Hammermill was under no obligation to cut timber and petitioners were entitled to retain the advance payments whether or not timber ever was cut.[3]

3. The decisions of the courts of appeals upon which petitioners rely (Pet. 5) are likewise distinguishable because they are not timber cases arising under Section 631(b), but deal instead with the sale of sand and gravel or fill dirt. *Wood* v. *United States,* 377 F.2d 300 (5th Cir.), cert. denied, 389 U.S. 977 (1967); *Freund* v. *United States,* 367 F.2d 776 (7th Cir. 1966); *Laudenslager* v. *Commissioner,* 305 F.2d 686, 691 (3d Cir. 1962). The question presented in

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[3]Nor do *Douglas* v. *Commissioner,* 322 U.S. 275 (1944), or *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308 (1956) support petitioners' position. The Treasury Regulations at issue in *Douglas* permitted percentage depletion in connection with advance payments made to lessors of mineral property, and the only question before the Court was whether the regulation was valid insofar as it required depletion deductions to be restored to income upon the expiration of the lease to the extent that minerals paid for in advance were not mined. See Treas. Reg. 94, § 23(n), art. 23(m)—10 (Revenue Act of 1936). Nor was any question involving the depletion allowance for advance payments involved in *Southwest Exploration Co.* The only question there was which taxpayer held a retained economic interest in certain oil, and therefore was entitled to the depletion allowance.

each of those cases was whether the owner of the deposits realized capital gains or ordinary income where the deposit was mined and paid for by another person. Significantly, in each case, the amount of mineral mined during the years in suit resulted in payment of more than the minimum annual royalties. *Wood* v. *United States, supra,* 377 F.2d at 302 n.3 and 303; *Laudenslager* v. *Commissioner, supra,* 305 F.2d at 688-690. See and compare, *Freund* v. *United States, supra,* 367 F.2d at 777 (minimum annual royalty of $12,000) with *Freund* v. *United States,* 17 A.F.T.R.2d para. 66-094 (N.D. Ill. 1966) (actual annual royalty payments exceeded $20,000 and $34,000, respectively). Thus, those courts did not consider the situation presented here, where payment was received in one year in connection with production to be undertaken, if at all, in the future. Thus, even on the assumption that sand and gravel cases are relevant, the question presented here could not have been presented in those cases.[4]

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[4]Petitioners erroneously contend (Pet. 7-8) that the decision below is contrary to Treasury Regulations on Income Tax, 26 C.F.R. 1.631-2(d) (Pet. App. A-20). Section 1.631-2(d)(1) provides that, when the conditions of Section 631(b) are otherwise met, advance payments for timber may qualify for capital gains treatment if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Section 1.631-2(d)(2) provides that advance payments, previously treated as capital gains, must be recomputed as ordinary income if the cutting contract expires, terminates or is abandoned before timber that has been paid for is cut. All that the decision below requires, however, is that a taxpayer be able to demonstrate that under the contract timber is required to be cut in return for advance payments. Even when a contract so provides, the possibility remains that the contract may expire or be abandoned with the obligation to cut remaining unsatisfied. In that event, the regulation requires that advance payments that are not attributable to harvested timber must be recomputed as ordinary income.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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